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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1980

UNITED STATES OF AMERICA,
Petitioner,

v.

ELWOOD SWANK and RITA SWANK,

UNITED STATES OF AMERICA,
Petitioner,

v.

BLACK HAWK COAL CORPORATION, INC.

UNITED STATES OF AMERICA,
Petitioner,

v.

BULL RUN MINING CO., INC.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF CLAIMS

BRIEF FOR RESPONDENT BLACK HAWK COAL CORPORATION, INC.

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QUESTION PRESENTED

Whether a provision in a coal mining lease permitting both parties thereto to terminate the lease on 30 days' notice without any grounds assigned deprives the lessee of an economic interest in the coal in place so that the lessee is not entitled to a depletion deduction under Sections 611(a) and 613 of the Internal Revenue Code of 1954, where the termination clause was never invoked or exercised by either party in the 13-year period during which the lessee mined the coal to exhaustion.

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STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth at U.S. Br. 1a-2a, in the text below at 12, 13, 30, and 44, n.4, and in the Appendix below at pp. 1a-7a.

STATEMENT

In the second of this trio of cases, involving respondent Black Hawk Coal Corporation, Inc., hereinafter simply "Black Hawk," the facts stipulated by the parties (J.A. 68a-73a) were adopted by the Court of Claims as its own findings of fact (Pet. 4a, note 2).

Black Hawk became lessee of the coal lands in question in 1964 (J.A. 69a, ¶ 3; for the text of the lease, see J.A. 73a-86a). "All coal feasible to mine has been extracted with mining operations ceasing in 1976" (J.A. 71a, ¶ 8). The tax years here involved are 1970 through 1972 (J.A. 69a, ¶ 2; *id.* 71a-72a, ¶¶ 12-13).

Black Hawk paid its lessor a lump sum or a royalty, whichever was greater (J.A. 77a-79a, ¶¶ 1-3), and also paid all taxes on the real estate, on the coal, and on its plant (J.A. 79a, ¶ 5). Black Hawk was free to sell its coal to anyone, and in fact never sold any of it either to its lessor or to the latter's sales agent (J.A. 70a-71a, ¶ 8).

The lease contained provisions for forfeiture for non-payment of rent (J.A. 80a, ¶ 7) and for insolvency (J.A. 84a-85a, ¶ 14), and also contained the following cancellation provision (J.A. 85a):

> 15th. This agreement of lease may be cancelled by either party hereto at any time by either party giving to the other thirty (30) days written notice of its or his intention to cancel same. Such notices shall be sufficient if given by registered letter postmarked in the United States mails, and thirty (30) days after receipt of such letter said agreement of lease shall stand cancelled and terminated, and shall be of no further force and effect.

In actual fact, the foregoing cancellation provision was never invoked by either party to the lease during the 13-year period in which the tract that it covered was mined to exhaustion (J.A. 69a, ¶ 4; *id.* 71a, ¶ 8).

All of the actual mining under the lease was done by independent contractors (J.A. 70a, ¶ 6).

None of those independent contractors made any claim for percentage depletion. Black Hawk's lessor made no claim for percentage depletion. Black Hawk is the sole claimant to a deduction for percentage depletion. (J.A. 71a, ¶ 10.)

Black Hawk's claim for a depletion deduction was denied by the Commissioner for the tax years in question; deficiencies were assessed and paid; claims for refund were then denied; and suit to recover the deficiencies paid was thereupon brought in the Court of Claims. (J.A. 71a-72a, ¶¶ 11-15.)

By stipulation, the only issue in the case is whether the presence of the cancellation clause in the lease precluded Black Hawk's entitlement to the claimed depletion deduction, an issue identical to that which the Court of Claims had decided in the lessee's favor under similar leases in the earlier case of *Bakertown Coal Co., Inc. v. United States,* 485 F.2d 633 (J.A. 72a, ¶¶ 16-18).

The Court of Claims followed that decision here. It held that Black Hawk under its lease had acquired an economic interest in the coal in place, and thus was entitled to a deduction for depletion; that the unexercised 30-day cancellation clause did not require a different result; and, pointing out that if Black Hawk could not deduct for depletion, no one could, entered judgment in Black Hawk's favor (Pet. 1a-16a; *id.* 19a-20a; 602 F.2d 348).

Because of conflict with the Third Circuit's ruling in *Whitmer v. C.I.R.*, 443 F.2d 170, this Court granted certiorari.

SUMMARY OF ARGUMENT

1. The purpose of the deduction for depletion, which has been in the income tax law since 1913, is to afford compensation to the owner for the reduction of a wasting asset. And even before equitable division of that deduction in the case of leases had been specifically provided by statute, a lessee of mineral lands was allowed to subtract a reasonable portion of the depletion deduction in respect of his property interest in the land. *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364.

2. After Congress settled the depletion allowance on a percentage basis, and oil and gas interests came to be fractionalized, this Court declared that entitlement to the depletion deduction depended on whether the taxpayer had acquired, by investment, an economic interest in the mineral in place, to which he was required to look for return of his capital. *Palmer v. Bender*, 287 U.S. 551. But ownership was essential. *Thomas v. Perkins*, 301 U.S. 655. Accordingly, when it was shown that a taxpayer had no capital investment in the mineral in the ground, it was held that he had no economic interest but only an economic advantage, and thus could not deduct for depletion. *Helvering v. Bankline Oil Co.*, 303 U.S. 362. The distinction thus drawn was carried virtually verbatim into a Treasury Regulation that is still in force, in which down to this very day there is not the slightest suggestion that an economic interest in the mineral in place vanishes simply because a cancellation clause was included in the instrument conveying that interest.

3. When contract coal miners undertook to claim a share in the depletion allowance, they were sustained by some courts, primarily by the Fourth Circuit, which distorted the concept of economic interest laid down here—by omitting the vital qualification, "in the mineral in place," and thus erroneously permitting depletion simply for investment "in the enterprise." Thereafter, when another circuit disagreed, this Court resolved the depletion issue against the contract coal miner, showing that he had never acquired any economic interest in the mineral in place. *Parsons v. Smith,* 359 U.S. 215.

The Fourth Circuit, however, refused to be convinced, and, by concentrating on particular incidents of the contract miners' arrangements, notably with respect to terminability and to a right to mine to exhaustion, in effect refused to follow *Parsons v. Smith.* It took this Court's resounding reversal of that recalcitrant tribunal in *Paragon Coal Co. v. Commissioner,* 380 U.S. 624, to establish the immateriality of both of those incidents, and to end for all time the claims of mere contract miners to share in the statutory depletion allowance.

4. Under the Internal Revenue Code, the Treasury Regulations, and the decisions of this Court, Black Hawk, which under its lease mined its tract of coal to exhaustion over a 13-year period, plainly acquired an economic interest in the coal in place, and thus is entitled to deduct for the depletion of that now completely wasted asset. And nothing in that Code, or in those Regulations, or in any decision here even intimates that a different result should follow simply because its lease contained a mutual termination clause that neither party thereto ever invoked or exercised over all of those years.

Contentions to the contrary, based on expressions as to the significance of terminability clauses—expressions that are taken from inapplicable and now wholly discredited contract miner cases—terminability clauses are simply irrelevant in the present lease situation. That is because the lessee here plainly had precisely what the contract miner never did, namely, the requisite economic interest in the coal in place.

Inasmuch as Black Hawk as lessee obviously qualifies for the depletion deduction in respect of all the tax years involved in this case, the unexercised termination clause in its lease is a matter of abstraction rather than of reality; and this is particularly true because the earliest depletion decisions by this Court always focused on the situation that existed during the tax years being litigated. It is significant that, in the present case, Black Hawk continued to mine coal for four years subsequent to the tax years presently in question, and that it only ceased when there was no more coal to mine.

It is enough that, as the Court of Claims said, Black Hawk at the very least could mine for 30 days; such a period is not too short. As a practical matter, no lessee would ever agree to less. And, since "the tax law deals in economic realities, not legal abstractions" (*Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 315), there is no need to examine whatever hypothetical possibilities might be conjured up by imaginative if unrealistic minds. Moreover, there is surely neither statutory nor decisional support for the Tax Court's grotesque rule that, while an unexercised 120-day cancellation clause does not defeat a lessee's right to deduct for depletion, similarly unexercised clauses providing for cancellation on 60-day or 30-day notice do.

The confusion engendered in the contract coal miner cases over ten years of unedifying litigating struggle, cases that mostly rested on disregard of principle with concurrent emphasis on mere contractual incidents, should warn against acceptance of the contentions now advanced by the Government. Those arguments similarly ignore the now settled law of entitlement to depletion, and similarly concentrate on the gossamer of a purely theoretical right to cancel the lease, a right never exercised here either in any of the cognizant tax years—or afterwards.

5. Equitable apportionment of the depletion allowance in the case of leases ceased to be applicable to coal lands in 1951; in that year Congress gave coal lessors capital gains treatment for their royalties, in lieu of any share in the deduction for depletion. That new departure in respect of coal leases is now § 631(c), I.R.C. 1954 (App. 2a-3a). Accordingly, as the Court of Claims twice pointed out, here as well as in the predecessor *Bakertown* case, only the lessees involved could qualify for percentage depletion. Therefore, said that court, if the lessees were denied the depletion deduction, the result would be that, although the entire leased coal tract had been mined to exhaustion, no depletion allowance would inure to anyone: The lessor is now barred by § 631(c), the contract miners by this Court's decisions in *Parsons* and *Paragon Coal.* If therefore the lessee were also barred, depletion would be wholly unavailable to any party in respect of a tract now wholly denuded of minerals. That result would completely frustrate the repeatedly enacted intent of Congress to provide appropriate compensation for the owner of a wasting asset that is used up in the course of producing income.

The Government, however, contends that "the capital gains treatment to which the lessors would be entitled under Section 631(c) does not deprive them of the benefits of depletion" (U.S. Br. 9, 23). But that argument is wholly untenable; it completely ignores the portion of Section 631(c) which expressly states, "Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal." *See also* Treas. Reg. §§ 1.611-1(b)(2) and 1.631-3(b)(1), p. 44, n. 4, below, and App. 5a.

ARGUMENT

The controlling fact in this case is that Black Hawk, a lessee of coal lands, mined those lands throughout the tax years involved and ultimately mined its property to exhaustion over a 13-year period. Its lease contained a provision permitting both parties thereto to terminate the relationship on 30 days' notice, without any grounds assigned. But that provision was never invoked or exercised by either lessor or lessee during any of the tax years now in litigation, or during all of the 13 years in which coal could be extracted.

The Court of Claims accordingly held that, in those circumstances, Black Hawk had acquired a sufficient economic interest in the coal in place to entitle it to a percentage depletion deduction under §§ 611(a) and 613 of the Internal Revenue Code of 1954. Indeed, said the Court of Claims, if Black Hawk were denied such a deduction, then the entire coal deposits comprised within its lease would have been exhausted without allowance of percentage depletion to any party, inasmuch as all lessors of coal lands had since 1951 been granted capital gains treatment of their lease royalties, and in

return had been expressly deprived by Congress of any allowance for percentage depletion.

The Government's contentions to the contrary, as well as rulings by the Third Circuit and the Tax Court in conflict with the Court of Claims, not only distort this Court's governing determinations, but fly in the face of the clear provisions of § 631(c), I.R.C. For those rulings rest on the flimsy abstraction of a cancellation clause that was never invoked or exercised over the 13-year period during which coal remained to be mined, and thus deny the reality of the economic interest in the coal in place that Black Hawk acquired by investment and then mined to exhaustion.

We think that we can best assist the Court in this matter by dispassionately narrating in detached fashion the course of the law of mineral depletion as it has been developed by legislation, by Treasury Regulations, and by decisions here. And, by laying bare the confusion found in the earlier case law dealing with the claims of contract coal miners who sought to share in that allowance, confusion that was a consequence of concentration on particular incidents rather than on economic realities, we think that we can help the Court avoid similar pitfalls now, pitfalls that would surely follow were the Government's present arguments pemitted to prevail.

I.

THE PURPOSE OF THE DEPLETION ALLOWANCE FOR MINERALS IS TO COMPENSATE THE OWNERS OF WASTING CAPITAL ASSETS, AND CONGRESS HAS FOR MANY YEARS PROVIDED THAT, IN THE CASE OF LEASES, THAT ALLOWANCE IS TO BE EQUITABLY APPORTIONED BETWEEN LESSOR AND LESSEE

A. The purpose of the depletion deduction

The deduction for the depletion of mineral assets appeared in the first income tax law passed after the adoption of the Sixteenth Amendment (Sec. II B [sixth] of the Act of Oct. 3, 1913, ch. 16, 38 Stat. 114, 167), and has been part of our tax law ever since. Its purpose was stated by Mr. Justice Brandeis for the Court in *United States v. Ludey*, 274 U.S. 295, 302, in these terms:

> The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year represents the reduction in the mineral contents of the reserves from which the product is taken. The reserves are recognized as wasting assets. The depletion effected by operation is likened to the using up of raw material in making the product of a manufacturing establishment.

A later formulation is that in *Parsons v. Smith*, 359 U.S. 215, 220:

> The purpose of the deduction for depletion is plain and has been many times declared by this Court. "It is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part

used up in production." *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 366. And see *United States v. Ludey*, 274 U.S. 295, 302; *Helvering v. Elbe Oil Land Development Co.*, 303 U.S. 372, 375; *Anderson v. Helvering*, 310 U.S. 404, 408; *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, 603. "[The depletion] exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 312. Save for its application only to gross income from mineral deposits and standing timber, the purpose of "the deduction for depletion does not differ from the deduction for depreciation." *United States v. Ludey*, 274 U.S., at 303. In short, the purpose of the depletion deduction is to permit the owner of a capital interest in mineral in place to make a tax-free recovery of that depleting capital asset.

Later restatements will be found in *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81, 86, 88, and in *Paragon Coal Co. v. Commissioner*, 380 U.S. 624, 631. But all are to the same effect: Mineral depletion for tax purposes is an allowance for the exhaustion of capital assets.

B. Apportionment of the depletion deduction between lessor and lessee

The question whether a lessee of mineral lands was entitled to any part of the depletion allowance arose before mineral leases were ever specifically mentioned in tax legislation. In *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364, which involved that question for the year 1917, the Court decided the query in the affirmative. It said (267 U.S. at 369, citations omitted):

> It is, of course, true that the leases here under review did not convey title to the unextracted ore deposits, * * * ; but is equally true that such leases, conferring upon the lessee the exclusive possession of the deposits and the valuable right of removing and reducing the ore to ownership, created a very real and substantial interest therein. * * * And there can be no doubt that such an interest is property. * * *

Accordingly, the Court held (267 U.S. at 369-70) that:

> The interest of respondent under its leases in the mines being property, its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year results from the plain terms of the statute, such deduction, since the property is an interest in mines, to be limited to the amount of the exhaustion of respondent's interest caused by the depletion of the mines during the taxable year.

Later, beginning with the Revenue Act of 1918, § 214(a)(10), ch. 18, 40 Stat. 1058, 1068, the depletion status of mineral lessees was placed on a statutory basis. Ever since then, successive Internal Revenue Acts have provided, with scarcely any change in phraseology—and here we quote from the current provision, § 611(b)(1), I.R.C. 1954—

> In the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee.[1]

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[1] Earlier enactments, in addition to § 214(a)(10) of the Revenue Act of 1918, are: Revenue Act of 1921, § 214(a)(10), ch. 136, 42 Stat. 227, 241; Revenue Act of 1924, § 214(a)(9), ch. 234, 43 Stat. 253, 270-271; Revenue Act of 1926, § 214(a)(9),

[footnote continued]

Similarly, Treas. Reg. § 1.611-1(c)(2) provides:

> In the case of a lease, the deduction for depletion under section 611 shall be equitably apportioned between the lessor and lessee.

See also Treas. Reg. § 1.613-1 (App. 3a-4a).

But, as we show under Point V, pp. 43-47, below, there has been no such apportionment in the case of coal leases since 1951, for in that year Congress gave the lessor of coal lands capital gains treatment of his royalties, and in return expressly provided that such lessor would no longer be entitled to depletion. That new arrangement is, as we shall show, still in effect.

We now turn to the decisions that arose out of the separation of interests in oil and gas deposits that did not involve formal leases.

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ch. 27, 44 Stat. 9, 27; Revenue Act of 1928, § 23(*l*), ch. 852, 45 Stat. 791, 800; Revenue Act of 1932, § 23(*l*), ch. 209, 47 Stat. 169, 181; Revenue Act of 1934, § 23(m), ch. 277, 48 Stat. 680, 690; Revenue Act of 1936, § 23(m), ch. 690, 49 Stat. 1648, 1660; Revenue Act of 1938, § 23(m), ch. 289, 52 Stat. 447, 462; and Internal Revenue Code of 1939, § 23(m), 53 Stat. 1, 14.

II.

WHEN OIL AND GAS INTERESTS CAME TO BE FRACTIONALIZED, THIS COURT REFINED THE CONCEPT OF THE DEPLETION ALLOWANCE, LIMITING ITS ENTITLEMENT TO THOSE WHO HAD ACQUIRED, BY INVESTMENT, AN ECONOMIC INTEREST IN THE MINERAL IN PLACE TO WHICH THEY LOOKED FOR A RETURN OF THEIR CAPITAL; AND THAT FORMULATION WAS CARRIED INTO A TREASURY REGULATION THAT IS STILL IN FORCE

A. Statutory development of the depletion allowance

Originally, the basis for calculating the depletion allowance was the discovery value of the mineral deposit. This proved extremely difficult to administer, and so in the Internal Revenue Act of 1926 Congress substituted a system of percentage depletion, which has remained in force ever since. That statutory development is fully traced in *United States v. Dakota-Montana Oil Co.*, 288 U.S. 459, 460-61, and in *Helvering v. Twin Bell Oil Syndicate*, 293 U.S. 312, 315-18.

The present percentage depletion provision is § 613(a), I.R.C. 1954, and the present percentage allowed to coal mines, appearing in § 613(b)(4), I.R.C. 1954, is 10 per cent.

B. Decisional development of the depletion allowance

When the ownership of coal lands is divided, the relationships are not complex: lessor and lessee, with sometimes a sublessor and sublessee as well. And either the owner of the entire fee, or the owner of the coal,

or the lessee or sublessee of the coal seams, may arrange for independent contractors to do the actual mining.

But in the area of oil and gas, where more sophisticated arrangements became first a frequent and then even the usual practice, it was soon apparent that a rigid application of conventional common law estates might work injustice. Accordingly, in *Palmer v. Bender,* 287 U.S. 551, this Court held that, where the owner of an oil and gas lease transferred his lease to another in consideration of a bonus and royalties, the bonus so received was a return *pro tanto* of the transferor's capital investment in the oil, which entitled him to a depletion allowance. The Court said (287 U.S. at 558):

> In the present case the two partnerships acquired, by the leases to them, complete legal control of the oil in place. Even though legal ownership of it, in a technical sense, remained in their lessor, they, as lessees, nevertheless acquired an economic interest in it which represented their capital investment and was subject to depletion under the statute. *Lynch v. Alworth-Stephens Co., supra* [267 U.S. 364]. When the two lessees transferred their operating rights to the two oil companies, whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil, in place, identical with that of a lessor. *Burnet v. Harmel, supra* [287 U.S. 103]; *Bankers Pocahontas Coal Co. v. Burnet, supra* [287 U.S. 308]. Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom, the original lessors, the two partnerships and their transferees, were entitled to share in the oil produced.

As later explained (*Thomas v. Perkins,* 301 U.S. 655, 661; our italics):

> If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. *Ownership was essential.*

Thereafter, in the leading case of *Helvering v. Bankline Oil Co.,* 303 U.S. 362, the Court after reviewing the cases denied depletion to a taxpayer who simply had a contract with the owner of gas wells to extract gasoline therefrom, on the basis that he had no investment in the gas in the ground, and, unlike Black Hawk here, "had no interest as lessor or lessee, or as sub-lessor or sub-lessee, in any of the producing wells" (303 U.S. at 366). Because of the later importance of the fundamental distinction there set forth, we must quote from Chief Justice Hughes' opinion for the Court (303 U.S. at 367, 368):

> It is true that the right to the depletion allowance does not depend upon any "particular form of legal interest in the mineral content of the land." We have said, with reference to oil wells, that it is enough if one "has an economic interest in the oil, in place, which is depleted by production"; that "the language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." *Palmer v. Bender, supra.* But the phrase "economic interest" is not to be taken as embracing a mere economic advantage derived from production, through a contractual relation to the owner,

by one who has no capital investment in the mineral deposit. See *Thomas v. Perkins*, 301 U.S. 655, 661.

* * *

Undoubtedly, respondent through its contracts obtained an economic advantage from the production of the gas, but that is not sufficient. The controlling fact is that respondent had no interest in the gas in place. Respondent had no capital investment in the mineral deposit which suffered depletion and is not entitled to the statutory allowance.

C. The foregoing decisional developments were carried into a Treasury Regulation that is still in force

The differentiation made in the *Bankline Oil* case, between an economic interest acquired by making a capital investment in the mineral in the ground, and a mere economic advantage arising out of a contract to extract that mineral, was copied almost verbatim into the first regulations under the Internal Revenue Code of 1939, after which there have been no major changes in the economic-interest *versus* economic-advantage paragraph. *See* Treas. Reg. 103, § 19.23(m)-1 (App. 7a); Treas. Reg. 111, § 29.23(m)-1; Treas. Reg. 118, § 39.23(m)-1(a) and (b). The regulation now in force, § 1.611-1(b)(1) of the Regulations under I.R.C. 1954, will be found at Pet. 24a-25a and at U.S. Br. 2a. It simply repeats, virtually verbatim, the *Bankline Oil* language just quoted.

It is particularly to be noted that nowhere in that regulation is there so much as a single word intimating, much less suggesting, that an economic interest in mineral

in place vanishes simply because somewhere in the instrument conveying that interest there has been inserted a cancellation clause.

D. Later oil and gas cases

Simply for the sake of completeness, we mention later oil and gas cases. Two others, decided on the same day as *Bankline Oil*, followed it, and were consistent with its teaching that mere economic advantage separated from a property interest in the oil in place was an insufficient basis for a depletion deduction. *Helvering v. O'Donnell*, 303 U.S. 370; *Helvering v. Elbe Oil Land Co.*, 303 U.S. 372.

But the decision a few years later in *Anderson v. Helvering*, 310 U.S. 404, did little to clarify matters, while two cases at the 1945 Term created little but disarray. Thus, in *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, the Court found it necessary to "explain" no less than three earlier decisions, while in *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25, the prevailing opinion was occupied with extensive "explanations" of one of those earlier decisions (*Elbe Oil Land Co., supra*) that the Court had just finished "explaining" in *Kirby Petroleum* a few months earlier.

We mention the foregoing cases only because they foreshadowed the confusion that plagued the course of case law involving contract coal miners who sought to share in the depletion allowance.

III.

WHEN PERSONS WHO HAD MERELY CONTRACTED WITH OWNERS OR LESSEES OF COAL DEPOSITS SOUGHT TO SHARE IN THE STATUTORY DEPLETION ALLOWANCE, THIS COURT REJECTED THEIR CLAIMS BECAUSE SUCH CONTRACTORS HAD NO ECONOMIC INTEREST IN THE COAL IN PLACE, WHETHER OR NOT THEIR CONTRACTS WERE TERMINABLE WITHOUT ANY GROUNDS ASSIGNED, AND WHETHER OR NOT THEIR CONTRACTS ENTITLED THEM TO MINE TO EXHAUSTION

A. The Fourth Circuit distorted the guideline for entitlement to the deduction for depletion, by omitting the essential qualification that the taxpayer's economic interest must be in the coal in place

The first instance of a coal mining contractor's claim for a share in the depletion allowance reaching the Federal Reporter was *C.I.R. v. Gregory Run Coal Co.*, 212 F.2d 52 (C.A. 4), *cert. den.*, 348 U.S. 828. There the Fourth Circuit allowed such a claim on the footing that the contractors "were entitled to share in the benefits of the statute which were designed to give compensation to persons *interested in the production of a wasting asset*." We have added the italics to emphasize the extent of the Fourth Circuit's departure from the standard of "an economic interest *in the* [minerals] *in place*," again our italics, which was first formulated by this Court and then carried virtually verbatim into the Treasury Regulations (*Palmer v. Bender*, 287 U.S. 551, 558; Treas. Reg. § 1.611[b][1]).

Speaking through the same judge, the Fourth Circuit then twice repeated—and enforced—its departure from the governing standard. In *Weirton Ice & Coal Sup. Co. v.*

C.I.R., 231 F.2d 531, it allowed the mining contractor's claim to depletion on the footing that (p. 535), "No stronger proof that Weirton had in effect the right to mine the coal could be found than in its willingness to invest $500,000 *in the enterprise*." Once more, our italics, this time to stress the difference between investing "in the enterprise" and investing in the coal in place. The same notion, that a "substantial investment in the enterprise" would qualify for the right to deduct for depletion, was once more applied in *C.I.R. v. Hamill Coal Corp.*, 239 F.2d 347, 350 (C.A. 4).

Another contract coal miner who was allowed depletion by the Fourth Circuit appeared in *Stilwell v. United States*, 250 F.2d 736, where a district court ruling to the contrary (152 F. Supp. 111 [W.D. Va.]) was reversed. Interestingly enough, this was one of the Fourth Circuit's earliest decisions attributing controlling significance to the factor of terminability (250 F.2d at 739). Even more interestingly, Stilwell's mining contract was with Paragon Jewel Coal Company, whose independent litigation—it was not and could not be a party to the *Stilwell* case—resulted ultimately in the final interment of all contract coal miners' hopes of sharing in the depletion deduction (380 U.S. 624).

B. When other circuits held to the contrary, this Court resolved the depletion issue against the contract coal miner in *Parsons v. Smith*, 359 U.S. 215, for the reason that he had never acquired any economic interest in the coal in place

The first Court of Appeals to disagree with the Fourth Circuit was the Ninth, which denied a contract stripper's claim to depletion on the basis that, since such a person

had no economic interest in the coal in place, he had a mere economic advantage, which was insufficient. *Usibelli v. C.I.R.*, 229 F.2d 539.

Yet, curiously enough, the Third Circuit had, in the case just preceding *Usibelli* in the reports, held just the contrary, following the Fourth Circuit's *Gregory Run* decision in holding that the contract stripper was entitled to depletion. *C.I.R. v. Mammoth Coal Co.*, 229 F.2d 535, *cert. den.*, 352 U.S. 824.

A few years later, however, the Third Circuit had second thoughts—sounder ones, as the event proved. It held that coal miners who had only stripping contracts were mere independent contractors, and hence not entitled to depletion. While stressing the circumstances that the several contracts involved were terminable—there were two cases—it determined after reviewing all the facts that it would not follow the Fourth Circuit decisions that allowed depletion in such cases. *Parsons v. Smith*, 255 F.2d 595; *Huss v. Smith*, 255 F.2d 599.

When the taxpayers then sought and obtained certiorari on the footing of the inter-circuit conflict (*Parsons v. Smith*, No. 218, Oct. T. 1958, Pet. 9; *Huss v. Smith*, No. 305, Oct. T. 1958, Pet. 10), this Court affirmed the Third Circuit's denial of any depletion to the contract strippers. *Parsons v. Smith*, 359 U.S. 215.

In response to the contractors who urged that their contractual right to mine coal from the designated lands, and the use of their equipment, organizations, and skills in doing so, should be regarded as the making of a capital investment in, and the acquisition of an economic interest in, the coal in place, the Court said (359 U.S. at 225):

But that fiction cannot be indulged here, for it is negated by the facts.

To recapitulate, the asserted fiction is opposed to the facts (1) that petitioners' investments were in their equipment, all of which was movable—not in the coal in place; (2) that their investments in equipment were recoverable through depreciation—not depletion; (3) that the contracts were completely terminable without cause on short notice; (4) that the landowners did not agree to surrender and did not actually surrender to petitioners any capital interest in the coal in place; (5) that the coal at all times, even after it was mined, belonged entirely to the landowners, and that petitioners could not sell or keep any of it but were required to deliver all that they mined to the landowners; (6) that petitioners were not to have any part of the proceeds of the sale of the coal, but, on the contrary, they were to be paid a fixed sum for each ton mined and delivered, which was, as stated in *Huss,* agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work"; and (7) that petitioners, thus, agreed to look only to the landowners for all sums to become due them under their contracts. The agreement of the landowners to pay a fixed sum per ton for mining and delivering the coal "was a personal covenant and did not purport to grant [petitioners] an interest in the [coal in place]." *Helvering v. O'Donnell,* 303 U.S. 370, 372. Surely these facts show that petitioners did not actually make any capital investment in, or acquire any economic interest in, the coal in place, and that they may not fictionally be regarded as having done so.

That ruling should have marked the end of all further efforts on the part of contract miners to obtain a deduc-

tion for depletion. But, unhappily for the state of the law, it was not.

C. The Fourth Circuit refused to be convinced, and by concentrating on particular incidents of the several contract coal miners' arrangements, in effect overruled *Parsons v. Smith*

The first contract coal miner's case to reach the Fourth Circuit following *Parsons v. Smith* was *United States v. Stallard,* 273 F.2d 847, where the decision in the district court had gone in favor of the contractor. That ruling was reversed, the contract coal miner's claim to depletion was denied, and the Court of Appeals duly quoted from *Parsons v. Smith.* But the heart of its decision was not the difference between obtaining by investment an economic interest in the coal in place as against obtaining the mere economic interest in the enterprise that under this Court's rulings and the applicable Treasury Regulations was a mere economic advantage. To the contrary, the Fourth Circuit's first post-*Parsons* ruling turned on the terms of the contract, and once more disregarded the fundamentals underlying allowance of the depletion deduction (273 F.2d at 851):

> If the operator has the absolute and exclusive right under the contract to exhaust the deposit, it is usually held that he has an economic interest in the mineral which entitles him to a depletion allowance, but if the owner has the right under the contract to terminate the relationship at will, the operator is deemed to be an employee of the owner or an independent contractor compensated at a specified rate with no right to the deduction.

Next, in *McCall v. C.I.R.,* 312 F.2d 699, the Fourth Circuit emphasized the importance of terminability over

every other consideration, and, because of a 30-day cancellation clause in the contract, denied the contract miner's claim to depletion.

Very shortly afterwards, in *Elm Development Co. v. C.I.R.*, 315 F.2d 488, the Fourth Circuit took a new tack in favor of the contract miner. It held that the stripper's right under its contract to mine to exhaustion, without any risk of termination, entitled it without more to a share of the depletion allowance (p. 491): "Its right to mine the coal without risk of cancellation is its economic interest in the coal in place." Nothing here about acquiring that interest by investment, which this Court's decisions and the Treasury Regulations required; all that was ventured was that the Fourth Circuit's earlier contract miner cases that disregarded the significance of terminability had been overruled by *Parsons v. Smith*; *see* 315 F.2d at 490-91.

Finally, in *Merritt v. C.I.R.*, 330 F.2d 161 (together with *C.I.R. v. Paragon Jewel Coal Co.*), the Fourth Circuit interpreted the contract miners' arrangements as meaning that (p. 163):

> * * * the operators had a continuing right to produce the coal and to be paid therefor at a price which was closely related to the market price. By virtue of these contracts and their respective expenditures under them, the operators shared with Paragon an economic interest in the mineral which brings them within the rationale of Parsons v. Smith * * *.

And that ruling was followed in *Cooper v. C.I.R.*, 330 F.2d 163, decided on the same day.

In actual effect, therefore, the Fourth Circuit was merely paying lip service to *Parsons v. Smith*, while simultaneously—and actually—wholly disregarding its teaching. But correction was now not long delayed.

D. This Court's reversal of the Fourth Circuit in *Paragon Coal Co. v. Commissioner*, 380 U.S. 624, established the immateriality both of contract terminability and of any contractual right to mine to exhaustion

When the *Merritt/Paragon Jewel* case was reviewed here, reversal came promptly.

First, the Court reaffirmed the rationale of *Parsons v. Smith,* and showed without difficulty how it had been improperly disregarded by the Fourth Circuit. Accordingly, the decision sustained the depletion claim of Paragon Jewel, lessee and sublessee of the coal lands in question, and disallowed the claims of its contract miners, the Merritts.

Second, the Court was assisted in reaching its conclusion by the circumstance that later revenue legislation had allowed depletion to contract cutters of timber without any mention of contract miners of coal (380 U.S. at 637).

Third, the Court was similarly assisted by other legislation that had made the depletion exclusively available to coal lessees and sublessees, relegating coal lessors to capital gains treatment on their royalties in return for loss of any deduction for depletion (380 U.S. at 636-37). (This is a matter that we discuss further under Point V below, at pp. 43-47.)

Finally, the Court's decision at long last laid to rest the significance formerly accorded to terminability and to the right to mine to exhaustion.

It will be recalled that, in *Parsons v. Smith,* one of the seven indicia there pointed out to negative the strippers' right to depletion (359 U.S. at 225, quoted

above at p. 22) was "(3) that the contracts were completely terminable without cause on short notice; * * *."

In *Paragon*, however, the Court said (380 U.S. at 630, 634):

> The contracts were also silent regarding termination and were apparently for an indefinite period. However, numerous contractors quit mining, and some sold their equipment, buildings, tracks, etc., to others.
>
> * * *
>
> In *Parsons* the contract was expressly terminable on short notice; here no specific right to terminate was mentioned in the agreement between the parties. However, as the Court of Appeals noted, "the contracts did not fix upon the operators an *obligation* to mine to exhaustion." In fact, many of them quit at any time they chose. [Italics in original.]

Further, said the Court (380 U.S. at 634-35):

> In any event, the right to mine even to exhaustion, *without more*, does not constitute an economic interest under *Parsons*, but is "a mere economic advantage derived from production, through a contractual relation to the owner, by one who has no capital investment in the mineral deposit." *Helvering v. Bankline Oil Co.*, 303 U.S. 362, 367 (1938).

Here we have ourselves italicized the words "without more" to contrast the situation of the contract miners in *Paragon Coal* with that of the lessee Black Hawk in the present case.

It is accordingly plain that this Court did not consider terminability or otherwise, or a right to mine to exhaustion or otherwise, as determinative factors in assessing

the contract miners' claims to a portion of the depletion allowance.[2]

Unhappily, however, as the present litigation demonstrates, so much had been said in so many now discredited cases about the significance or otherwise of terminability provisions in contract miners' agreements that, although the Fourth Circuit at long length acquiesced in reversal in the contract miner situation, *see Lawson v. C.I.R.*, 350 F.2d 396, other courts, differing from the rulings of the Court of Claims in *Bakertown* and in the present case, have continued to concentrate on terminability provisions, not in connection with mere mining contracts, but in dealing with *bona fide* leases such as are in question here.

Those courts in conflict with the Court of Claims have thus wholly disregarded the true basis for allowing or denying the depletion deduction, namely, whether the taxpayer had acquired, by investment, an economic interest in the wasting asset, the coal in place. The contract miners, who lacked such an interest, did not become entitled to the deduction simply because their contracts happened not to be terminable; that much is clear from this Court's decisions. Similarly, we shall now show that the respondent lessee here, which plainly had such an interest, did not lose its entitlement to a depletion deduction simply because its lease, though theoretically terminable without any grounds assigned, was not in fact cancelled during the tax years involved.

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[2] *Cooper v. C.I.R.*, 330 F.2d 163, decided by the Fourth Circuit on the same day as the *Paragon/Merritt* case, was reversed here on the Commissioner's petition for certiorari, without argument, on the authority of *Paragon Coal.* 381 U.S. 274.

IV.

RESPONDENT BLACK HAWK, A LESSEE OF COAL LANDS THAT MINED ITS LEASE TO EXHAUSTION OVER A 13-YEAR PERIOD, COULD NOT BE DEPRIVED OF ITS STATUTORY RIGHT TO A DEPLETION DEDUCTION SIMPLY BECAUSE OF A MUTUAL CANCELLATION CLAUSE IN ITS LEASE THAT WAS NEVER INVOKED OR EXERCISED OVER ALL OF THOSE YEARS

A. The lease here and the 13 years' dealings thereunder during which the leased coal tract was mined to exhaustion show that, under the Internal Revenue Code, the Treasury Regulations, and the decisions of this Court, respondent Black Hawk acquired by investment an economic interest in the coal in place, and thus became entitled to deduct for depletion of that wasting asset

Briefly to summarize what is set forth in more detail above (pp. 2-3), Black Hawk became lessee of coal lands in 1964, which by 1976 it had mined to exhaustion. The lease contained provisions for termination in the event of specified defaults, as well as a clause that permitted mutual cancellation by both parties without grounds assigned. But none of the termination provisions was ever invoked or exercised during all of the 13-year period during which Black Hawk mined its tract to exhaustion.

All of the actual mining was done by independent contractors. But neither the independent contractors nor the lessor have claimed any depletion allowance; the lessee Black Hawk is the only party to the enterprise that has sought to deduct for depletion.

On those facts we can dismiss the complications that arose when oil and gas interests were fractionalized, as well as the incidents involved in the contract miners' extended campaign to obtain depletion in respect of an asset they had never owned. Here the relevant residue of this Court's decisions clearly demonstrates that the undisputed facts just capsulated constitute the essential prerequisite to the allowance of a depletion deduction, namely, the acquisition by investment of an economic interest in the coal in place.

And that is precisely what the Court of Claims said in its earlier *Bakertown* decision (485 F.2d at 642), a decision followed here (Pet. 5a):

> Through the leases which they held, plaintiffs acquired an interest in the coal in place. The leases authorized them to extract and dispose of the coal underlying the leased premises to whomever and at whatever prices they chose. The income which they received was solely derived from and tied to the extraction and sale of the coal during the taxable years involved. The existence of these factors is sufficient to constitute a depletable interest under the rules that have been laid down by the Supreme Court from *Lynch v. Alworth-Stephens* [267 U.S. 364] and *Palmer v. Bender* [287 U.S. 551] to the present time.

Those rules can also be found in Treas. Reg. § 1.611-1 (b)(1), set forth at U.S. Br. 2a, of which this Court said when it was being considered in the *Paragon Coal* case, 380 U.S. at 636: "This Regulation has survived through successive amendments of the Internal Revenue Code and therefore is entitled to great weight."

We agree—and we urge that its weight cannot properly be minimized now. For, significantly, there is not a single word in that Regulation, nor for that matter in

any of this Court's depletion decisions, which suggests that the economic interest contemplated is diminished in any degree simply because of the presence of cancellation clauses that are never exercised.

Again significantly, there is not a single whisper anywhere in the multitudinous provisions of the current Internal Revenue Code dealing with percentage depletion suggesting or even intimating that a mineral lessee loses its entitlement to a deduction for depletion simply because its lease contains an unexercised cancellation clause. In this connection, we invite inspection of §§ 611(a) and 613(a), both at U.S. Br. 1a; and of §§ 613(c), 614(a), and 631(c), set forth below at App. 1a-3a. Not a single syllable in any of those sections so much as mentions a terminability clause.

Attention may be properly directed to Section 614(a), I.R.C. 1954, which provides as follows:

> **§ 614. Definition of property**
>
> **(a) General rule.**— For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

Again, there is not the slightest suggestion in the Internal Revenue Code that property ceases to be such simply because the interest owned by the taxpayer is subject to termination, much less when there has never been any termination.

The short of the matter is that the Government's contentions in the present case, which urge that the mere presence of an unexercised termination provision negatives not only property in a mineral deposit but also the right to a depletion allowance thereon, are entirely at

variance with what the Congress, the Treasury Department, and this Court have consistently decreed.

B. Expressions as to the significance of termination clauses that are taken from inapplicable and now wholly discredited contract coal miner cases are simply irrelevant in the present lease situation

As we have shown in our recital under Point III, pp. 19-27 above, the ultimately unsuccessful efforts of contract coal miners to share in the depletion allowance, in respect of a mineral asset in which they had absolutely no shred of ownership, led to emphasis on numerous subsidiary factors such as, preeminently, the terminability or otherwise of the mining contracts in question.

The decision in *Parsons v. Smith,* 359 U.S. 215, should have been enough to dispose of the contract miners' claims, but in view of the intractable backsliding of the Fourth Circuit in that area, it required *Paragon Coal Co. v. Commissioner,* 380 U.S. 624, to do so—and, in the process, to demonstrate the immateriality of whether or not the contract miners' arrangements were terminable.

None the less, considerable insight can still be derived from examining the basically irreconcilable decisions of the several Courts of Appeals concerned. Thus, the Third Circuit, whose general approach won approval in *Parsons v. Smith,* had stressed the significance of terminability (*Parsons v. Smith,* 255 F.2d 595, 597; *Huss v. Smith,* 255 F.2d 599, 601; *cf.* dissent at 602). Contrariwise, the Fourth Circuit, whose more sympathetic approach to contract miners' tax problems was so resoundingly disapproved in *Paragon Coal,* had earlier minimized the mere existence of a termination clause (*Weirton Ice & Coal Sup. Co. v. C.I.R.,* 231 F.2d 531,

535). Later, in *Stilwell v. United States,* 250 F.2d 736, the Fourth Circuit stressed non-terminability as the decisive factor in a contract coal miner's case. After that, following this Court's *sub silentio* disapproval of the Fourth Circuit's basic approach in contract miner cases, that tribunal then undertook to emphasize terminability to the exclusion of all other factors. *United States v. Stallard,* 273 F.2d 847, 851; *McCall v. C.I.R.,* 312 F.2d 699, 703-06; *Elm Development Co. v. C.I.R.,* 315 F.2d 488, 489-91; *Merritt v. C.I.R.,* 330 F.2d 161, 162-63; *Cooper v. C.I.R.,* 330 F.2d 163, 164.

Finally, when the last two cases cited were reversed here (*Paragon Coal Co. v. Commissioner,* 380 U.S. 624; *Commissioner v. Cooper,* 381 U.S. 274), this Court demonstrated the utter immateriality of terminability or otherwise (*Paragon Coal,* 380 U.S. at 630, 634-35, quoted above at p. 26).

The core of the matter is that contract miners do not have any economic interest in the coal in place, while lessees do. Contract miners in consequence have no right to depletion, since they never had any ownership in the wasting minerals (*cf. Thomas v. Perkins,* 301 U.S. at 661, "Ownership was essential"); lessees however do, as under § 614(a), I.R.C., quoted above at p. 30. they have "property" in the mineral deposit.

The result is that the contract miner cases are wholly irrelevant, and entirely out of point, in situations involving leases. Yet the Government makes precisely that error in the authorities it adduces in the present lease case.

Thus, *Costantino v. Commissioner,* 445 F.2d 405 (C.A. 3), cited at U.S. Br. 19, involved simply a contract miner. And each of the six cases cited in the first paragraph of U.S. Br. 22 is likewise a contract miner case,

three of which have already been discussed above: *Stallard,* 273 F.2d 847 (C.A. 4); *McCall,* 312 F.2d 699 (C.A. 4); *Usibelli,* 229 F.2d 539 (C.A. 9). But the newly adduced decisions are in no sense different: *United States v. Wade,* 381 F.2d 345 (C.A. 5); *Ramey v. Commissioner,* 47 T.C. 363, *aff'd,* 398 F.2d 478 (C.A. 6); *Rissler & McMurry Co. v. United States,* 480 F.2d 684 (C.A. 10). These likewise involved only contract miners, not lessees.

Therefore each of the authorities relied on by the Government for reversal here involves, not leases such as were held by Black Hawk and the other respondents here, who qualify under the Internal Revenue Code and the Treasury Regulations and this Court's decisions for a depletion allowance, but only contract miners, whose claims this Court decisively rejected, first in *Parsons v. Smith,* 359 U.S. 215, and then again in *Paragon Coal Co. v. Commissioner,* 380 U.S. 624, because not a single one of those contract miners had the slightest economic interest in the coal in place.

It follows that all of the foregoing decisions put forward by the Government are quite without relevance to the issue now before the Court.

Similarly, *Mullins v. Commissioner,* 48 T.C. 571, also relied on by the Government here (U.S. Br. 19), although it did indeed involve a lease, was rested (48 T.C. at 583) on contract miner cases: *Stallard,* 273 F.2d 847 (C.A. 4); *McCall,* 312 F.2d 699 (C.A. 4); and *Stilwell,* 250 F.2d 736 (C.A. 4). But the Tax Court's authorities were not only irrelevant contract miner cases, each of the three had already been discredited by this Court's subsequent decisions in *Parsons* and in *Paragon Coal.* Indeed, the Tax Court was apparently wholly unaware that Stilwell, whose claim the Fourth Circuit had allowed in 250 F.2d,

was a Paragon Coal contractor whose arrangements were identical with those of the Merritts, other Paragon Coal contractors, who came a cropper in the *Paragon Coal* case here, 380 U.S. 624.

Accordingly, when the Court of Claims first faced the terminable-but-unterminated lease situation now presented in this case, it quoted with approval Chief Judge Drennen's dissent in the *Mullins* case (*Bakertown Coal Co. v. United States*, 485 F.2d 633, 641, quoting from 48 T.C. at 584-85), and refused to follow the Tax Court.[3]

The short of the matter is that, if attention be focused on the acquisition, by investment, of an economic interest in the mineral in place, which is the only property that qualifies for a depletion allowance, the contract miner cases are wholly out of point: They are entirely irrelevant since it is now at long last entirely clear that contract miners have no such interest and hence are entitled to no such allowance.

Consequently, whatever was earlier said by some of the lower federal courts in contract miner cases about the significance or otherwise of termination clauses, expressions antedating the ultimate denial here of contract miners' claims to depletion, becomes wholly irrelevant here, where the respondent lessee plainly has the requisite economic interest. And to inject those now disapproved and quite inapplicable expressions here, as the Government does in its brief, is simply to introduce counterproductive clutter into the discussion.

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[3]It needs to be pointed out that it was Judge Drennen's decision in the *Paragon Coal/Merritt* controversy (39 T.C. 257) which, after reversal by the Fourth Circuit (330 F.2d 161), was reinstated by this Court (380 U.S. 624, 626).

In its earlier *Bakertown* decision, on which its ruling in this case was rested (Pet. 8-9, 5a; U.S. Br. 6-7, 19-20), the Court of Claims said precisely what we have just set forth immediately above (485 F.2d at 636):

> It seems to us that the Government is here attempting to remove transactions from the traditional ambit of economic interest by resort to a principle that it sponsored to liberalize and expand that established concept to encompass transactions not theretofore within it. The erroneous transposition is as between lessees; persons who have acquired the right to remove and retain mineral underlying the leased premises, and mining contractors who, although functionally involved in the production of saleable mineral (and therefore financially interested in the life of the deposit as a source of continuing need for their services), have no effective authority over production and acquire no ownership of the extracted mineral.

C. Inasmuch as the present lease obviously qualifies for the depletion deduction in respect of all the tax years here involved, the unexercised termination clause is a matter of abstraction and not of reality

At the time of the tax years here involved, 1970 through 1972, Black Hawk's lease had been in force from seven to nine years. That lease was never sought to be terminated during those tax years, and in fact Black Hawk continued to mine for four years more, stopping only in 1976 when all the coal feasible to mine had been extracted (J.A. 71a, ¶ 8).

If we bear in mind what the Court said in another depletion case (*Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 315), that "the tax law deals in

economic realities, not legal abstractions," then it is plain that, during the tax years now in litigation, Black Hawk had a depletable interest. The Court of Claims so held twice, first in *Bakertown* and then again here. We submit that it properly regarded the mere existence of a termination clause that was never invoked or exercised during the tax years as—to quote Mr. Justice Holmes in another connection (*Myers v. United States*, 272 U.S. 52, 177)—"spider's webs inadequate to control the dominant facts."

Accordingly, the Court of Claims was clearly right, and we find a convincing rationale for its conclusion in a Fourth Circuit case which, although plainly not law today as to its substance, nonetheless persuasively emphasizes the importance of looking to the tax years involved. *See Weirton Ice & Coal Sup. Co. v. C.I.R.*, 231 F.2d 531, 535:

> It is of no moment that the owner of the mineral, as in other cases in which the right of an extractor to a deduction for depletion has been upheld, had the option to terminate the arrangement at any time, for as the event proved, Weirton actually mined the coal during all of the taxable years.

Although the Fourth Circuit later disapproved this and similar expressions, disapproval that was a consequence of its own erroneous reading of *Parsons v. Smith*, 359 U.S. 215, as turning solely on terminability, *see Elm Development Co. v. C.I.R.*, 315 F.2d at 490, we submit that the passage just quoted sets forth the correct approach.

Indeed, that concentration on the tax years actually involved in the litigation, without regard to possibilities that never in fact materialized, was foreshadowed, and applied, in the first depletion case decided by this Court, *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364. The emphasis in that decision was uniformly on the taxable

year actually in issue; we quote some representative passages from the opinion (pp. 369–70):

> the product thereof mined and sold during the taxable year
>
> * * *
>
> its right to deduct a reasonable allowance for exhaustion of such property, if there be any, during the taxable year
>
> * * *
>
> the depletion of the mines during the taxable year
>
> * * *
>
> the product thereof which has been mined and sold during the year for which the return and computation are made

And the same focus on the tax year in litigation appears in the precise terms of the opinion in *United States v. Ludey,* 274 U.S. 295, 302, from which quotation has already been made:

> The depletion charge permitted as a deduction from the gross income in determining the taxable income of mines for any year * * *.

We can test the teaching of the foregoing rulings by supposing a ten-year mineral lease, running let us say from January 1, 1969, through December 31, 1978, in which the tax years being contested are 1973 through 1975. Suppose further that this lease was terminated on June 30, 1977, because the lessee ceased to pay royalties; could it be supposed for a moment that the lessee would in consequence lose his depletion deduction for the earlier tax years that are in dispute? Plainly not, so what difference of substance would there be if the lease instead of being terminated for non-payment had been cancelled on the same or on a later date simply because the lessor, acting on whim, had sought to resume mining himself or through the agency of a contractor not

previously employed by the lessee? Again, suppose that the lessee himself took advantage of the cancellation clause to terminate the lease on June 30, 1977: In all those instances, the answer must be, There is no difference, and the lessee is still entitled to his depletion deduction for the earlier tax years that are being litigated.

How then, it may be asked, does the right to depletion succumb to the mere overhanging threat of a termination clause that is never even exercised, either during the tax years in litigation, or afterwards?

Some thirty years ago, the Treasury ruled that, if a contractor were assured of at least twelve months of uninterrupted mining, it would be entitled to depletion. GCM 26290, 1950-1 Cum. Bull. 42. The Tax Court since then has drawn a finer line. It has held that a 30-day or a 60-day cancellation clause is fatal, although a termination provision requiring 120 days' notice does not deprive a mineral lessee of his deduction for depletion. *Weaver v. Commissioner,* 72 T.C. 594, 608-09. We confess ourselves quite unable to find, either in the statutes or in the applicable regulations or in this Court's decisions, the slightest basis for distinctions so ephemeral and so imaginatively fanciful.

The Court of Claims in this case decided that a 30-day cancellation clause would not be fatal, because (Pet. 8a) "We cannot say *a priori* that a month's period is too short for a miner to expect to extract a substantial amount of coal. There is no such proof before us and we do not believe it is a matter of judicial notice. Like *Bakertown,* these cases do not involve leases terminable within a single day."

Like *Bakertown* (485 F.2d at 642):

> This is not a case in which we are called upon to decide whether plaintiffs would be entitled to

> recover if the duration of their leases was for only one day, or if their leases were terminable at the will of the lessor without advance written notice and without cause.

Nor need this Court decide or even speculate about such a hypothetical situation, for the excellent reason that no individual or corporate lessee would ever agree to any such economically impossible arrangement. For as this Court has said (350 U.S. at 315, quoted above at pp. 35-36), "the tax law deals in economic realities, not legal atstractions."

The reality here is that, for the three tax years now in question, for the six years preceding, and for the four years following until the coal underlying the leased tract had been mined to exhaustion, Black Hawk's lease was never terminated.

D. To attach any significance whatever to wholly unexercised termination clauses in coal leases would inevitably risk a repetition of the confusion that permeated the contract coal miner cases over so many years

We noted above, p. 18, the confusion that characterized the two oil depletion cases decided at the 1945 Term, *Kirby Petroleum Co. v. Commissioner*, 326 U.S. 599, and *Burton-Sutton Oil Co. v. Commissioner*, 328 U.S. 25. The result in the latter case impelled one member of the Court to say (328 U.S. at 38):

> Nothing better illustrates the gossamer lines that have been drawn by this Court in tax cases than the distinction made in the Court's opinion between *Helvering v. Elbe Oil Land Co.*, 303 U.S. 372, and this case. To draw such distinctions, which hardly

> can be held in the mind longer than it takes to state them, does not achieve the attainable certainty that is such a desideratum in tax matters, nor does it make generally for respect of law.

Interestingly enough, it was precisely what this Court had said in *Burton-Sutton,* involving oil, that impelled two separate circuits to concede a depletion allowance to contract coal miners in the earliest decisions involving such claims, cases that *Parsons v. Smith,* 359 U.S. 215, and *Paragon Coal Co. v. Commissioner,* 380 U.S. 624, have now clearly shown to have been wrongly decided. *See C.I.R. v. Gregory Run Coal Co.,* 212 F.2d 52, 55-61 (C.A. 4), and *C.I.R. v. Mammoth Coal Co.,* 229 F.2d 535, 537 (C.A. 3).

In the latter two decisions, as we have already shown at length, pp. 19, 21, above, principle was forgotten in concentration on particular incidents, with resultant confusion that extended through a decade of litigation. That far from glorious episode in the hammering out of the law of depletion would surely be repeated now if, as the Government urges here, the reality of the lessee's economic interest in the coal in place were brushed aside in favor of simply fixing on a particular incident of its lease, namely, a clause therein that neither of the parties ever made operative.

Two factors, we think, contributed to the turbulence found in the earlier depletion cases.

First, emphasis was too often placed, not on clear rules, not on broad principles, but on "the circumstances of this case" (*Commissioner v. Southwest Exploration Co.,* 350 U.S. 308, 317), and on "the facts" and "these facts" (*Parsons v. Smith,* 359 U.S. 215, 225). Thus, inevitably, there was engendered an emphasis on the amorphous totality of each separate tax litigation,

encouraging first counsel and then the courts to pick and choose from among particular incidents that seemed most likely to lead to the result desired. Thus, after the Fourth Circuit's basic pro-contract-miner approach had been disapproved in *Parsons v. Smith,* it interpreted that decision as making all contract miner cases turn on terminability—even though, as the *Parsons* opinion shows, terminability was only one out of seven enumerated elements considered.

The second factor contributing to the confusion was perhaps inevitable in the context of tax litigation. As phrased by Judge Goodrich in *Denise Coal Co. v. C.I.R.*, 271 F.2d 930, 933 (C.A. 3), "Both stripper and owner may not have the depletion allowance. The Commissioner seems to take the position of opposing either party who demands it." Otherwise stated, the chief tax official never sought to formulate official tax guidelines. It was only when both claimants happened to become parties to consolidated proceedings that the Commissioner ever took a doctrinal position (*Southwest Exploration,* 350 U.S. at 309 note 1; *Paragon Coal,* 380 U.S. at 626 note 2).

In order to preclude similar confusion in what we may call the new generation of coal depletion cases, now that lessors are denied depletion by statute and the contract miners have finally been eliminated as contenders, we strongly urge that the errors of the past be not repeated in cases such as this one that involve leases.

In the earlier cases, the mistake arose because the circumstance that the contract miners' economic interest was not in the coal in place was ignored, and attention became riveted on the terminability and other incidents of their contracts. Today a similar mistake would be repeated if the Court were now to ignore the circum-

stance that the lessee clearly has a depletable interest in the coal that it mined during the tax years, and were to look only at a termination clause in its lease that in fact never became operative. And confusion would be worse confounded were particular emphasis to be placed on the time specified in such unexercised clause, so that the right to depletion would turn on whether that wholly hypothetical event required a notice of one, or two, or four months—as the Tax Court is now deciding, *see Weaver v. Commissioner*, 72 T.C. 594, 608-09. Indeed, such an approach would signal a return to the "gossamer lines" about which Mr. Justice Frankfurter so presciently complained in *Burton-Sutton*, 328 U.S. at 38, *supra* pp. 39-40.

If we accept the proposition first announced by Mr. Justice Holmes just a century ago (*The Common Law* [1881] 1), that the life of the law has been experience, then the painful years of hammering out the contract coal miners' non-entitlement to depletion should warn against acceptance of the purely hypothetical propositions and the tenuous distinctions now being advanced in coal lessee cases by the Government here, by the Third Circuit in its ill-starred *Whitmer* case (443 F.2d 170), and by the Tax Court in a series of decisions that obviously ignore settled principles in favor of discredited earlier cases, irrelevant incidents, and untenable distinctions.

V.

IN VIEW OF § 631(c), I.R.C. 1954, WHICH GRANTS CAPITAL GAINS TREATMENT TO COAL LESSORS, BUT THEN SPECIFICALLY PROVIDES THAT SUCH LESSORS "SHALL NOT BE ENTITLED TO THE ALLOWANCE FOR PERCENTAGE DEPLETION PROVIDED IN SECTION 613 WITH RESPECT TO SUCH COAL," THE COURT OF CLAIMS WAS PLAINLY CORRECT IN STATING THAT, UNLESS THE LESSEE HERE WAS ALLOWED DEPLETION, THERE WOULD BE NO DEPLETION DEDUCTION FOR ANYONE DESPITE THE EXHAUSTION OF ALL THE COAL UNDERLYING THE LEASED LANDS; AND THE GOVERNMENT'S ARGUMENT TO THE CONTRARY SIMPLY IGNORES THE EXPLICIT TERMS OF THE STATUTE

A. Since 1951, lessors of coal lands have been granted capital gains treatment of their royalties in lieu of any depletion depletion allowance

As we have shown (pp. 12-13, above), successive revenue acts from 1918 down to the present day have provided for apportionment of the depletion allowance in the case of leases. But in 1951, Congress made a significant change in respect of coal leases, providing that, instead of being allowed part of the depletion deduction as theretofore, the lessor would be granted capital gains treatment on his royalties but in return would no longer be permitted to deduct for depletion. *See* § 325 of the Revenue Act of 1951, P.L. 183, 65 Stat. 452, 501 (App. 5a-6a). That new provision was clarified in the 1954 Internal Revenue Code in respects not presently material, and in 1964 iron ore was included within its scope.

In its present form, § 631(c), I.R.C. 1954, that provision appears at App. 2a-3a. The portion pertinent here is the sentence reading:

> Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore.

This provision is adopted in Treas. Reg. § 1.631-3(b)(1) (App. 5a).[4]

It was unquestionably because of the provision just quoted, the operative language of which has remained unchanged since 1951, that Black Hawk's lessor never made any claim for percentage depletion (J.A. 71a, ¶ 10). For, obviously, no such claim could possibly have succeeded in the face of what has just been set forth.

B. Accordingly, as the Court of Claims pointed out, denial of depletion to the lessee here would mean that, although the entire leased tract was mined to exhaustion over a 13-year period, no depletion allowance thereon could be given anyone

In the *Paragon Coal* case, 380 U.S. 624, the contest for a share of the depletion allowance took place between the lessee/sublessee on the one hand and the contract miners on the other; the latter group lost. In the course

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[4] *See also* Treas. Reg. § 1.611-1(b)(2) which provides:

"(2) No depletion deduction shall be allowed the owner with respect to any timber, coal, or domestic iron ore that such owner has disposed of under any form of contract by virtue of which he retains an economic interest in such timber, coal, or domestic iron ore, if such disposal is considered a sale of timber, coal, or domestic iron ore under section 631(b) or (c)."

of its opinion, the Court made mention of the 1951 coal amendments as an additional ground in support of its conclusions, *see* 380 U.S. at 636-37, and that reference was noted by the Court of Claims in the earlier *Bakertown* case, 485 F.2d at 642.

In the present case, as has just been noted, Black Hawk's lessor made no claim for depletion; it could not do so in the face of § 631(c). Here, likewise, the contract miners made no claim for depletion (J.A. 71a, ¶ 10); they could not do so either after the *Paragon Coal* decision, 380 U.S. 624.

Accordingly, both in the earlier *Bakertown* case (485 F.2d at 642) as well as here (Pet. 9a), the Court of Claims pointed out that if the lessees "are not entitled, there will be no depletion on the coal mined under these leases." And it also said here (*ibid.*), in answer to the Government's argument that every applicant must show its own entitlement, "We agree, but think that Congress, in establishing percentage depletion, intended that, except for extraordinary instances, someone should be entitled to depletion on all mined coal covered by the Code provision. *Cf.* I.R.C. § 613(c)."

This Court, from *Lynch v. Alworth-Stephens Co.*, 267 U.S. 364, and *United States v. Ludey*, 274 U.S. 295, down through *Paragon Coal Co. v. Commissioner*, 380 U.S. 624, has iterated and reiterated that the purpose of the depletion allowance is to compensate for the loss of a wasting asset used up in the course of producing income. Surely it would be monstrous to hold here that, after all the coal had been mined to exhaustion over a 13-year period, the only party now entitled by law to depletion, the lessee Black Hawk, should lose that entitlement simply because of a mutual termination

clause that was never availed of by either party during all of those years. Any such result would completely frustrate the oft-expressed intent of Congress to compensate the owner of a wasting asset.

C. The Government's argument that the lessor here is entitled to both capital gains plus depletion allowance in addition simply ignores the clear and explicit terms of § 631(c)

The Government argues (U.S. Br. 22) that "there is no basis for the Court of Claims' observation * * * that if respondents are not entitled to the depletion deduction, 'there will be no depletion on the coal mined under these leases' (Pet. App. 9a)."

The Government then goes on to assert (U.S. Br. 23) that "the capital gains treatment to which the lessors would be entitled under Section 631(c) does not deprive them of the benefits of depletion," citing four cases that do not have the slightest bearing on that provision either as it now stands or as it was first enacted in 1951:

(a) Two of its cases antedate 1951: *Burnet v. Harmel*, 287 U.S. 103 (1932); *Herring v. Commissioner*, 293 U.S. 322 (1934).

(b) A third case cited, *Parsons v. Smith*, 359 U.S. 215, although decided in 1959, involved the tax years 1945-49, which of course antedated 1951; *see* No. 218, Oct. T. 1958, R. 8-10. The companion case decided with *Parsons*, *Huss*, dealt with the tax years 1944-47; *see* the recital in *Huss v. Smith*, 150 F. Supp. 224, 266-27 (E.D. Pa.).

(c) The last case cited, *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, involved oil and not

coal—and neither § 631(c) nor its 1951 predecessor has any application whatever to lessors of oil or gas lands.

Plainly, therefore, the Government's authorities do not and cannot support its proposition of double entitlement for coal lessors for which they are cited.

What the Government never mentions, and to which we feel constrained to direct its attention, is the portion of § 631(c) which completely demolishes its double entitlement contention:

> Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore.[5]

The short of the matter is that the Government's contention that a coal lessor is entitled to depletion as well as to capital gains simply flies in the face of the plain language of Section 631(c). There is no need to belabor that matter further.

The result is that the Court of Claims was correct in saying that, if lessee Black Hawk received no depletion, no one else could. And, for the reasons fully set forth above, the Court of Claims was also correct in holding that the lessee Black Hawk, which had mined to exhaustion all of the coal underlying its lease over a 13-year period, was entitled under statute, regulations, and decisions here, to deduct for depletion—and that this

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[5]The committee reports do not add much if anything to the statutory language. *See* H.R. Rep. No. 586, pp. 31-32, 117-18; Sen. Rep. No. 781, Part 2, pp. 43-45; H.R. Rep. No. 1179, pp. 18, 77; all 82d Cong., 1st sess. But the sentence just quoted is so clear that any legislative comment thereon, serving only to repeat the obvious, would be quite unnecessary. Accordingly, as in *Greenwood v. United States*, 350 U.S. 366, 374, "this is a case for applying the canon of construction of the wag who said, when the legislative history is doubtful, go to the statute."

entitlement did not vanish into thin air simply because its lease might have been but in fact never was terminated during all of that time.

CONCLUSION

It is therefore respectfully submitted that the judgment below should be affirmed.

Respectfully submitted,

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APPENDIX

STATUTES AND REGULATIONS INVOLVED

(1) Internal Revenue Code of 1954 (26 U.S.C.)

Section 613(c). Percentage Depletion. Definition of Gross Income From Property.—For purposes of this section—

(1) Gross Income From the Property.—The term "gross income from the property" means, in the case of a property other than an oil or gas well and other than a geothermal deposit, the gross income from mining.

(2) Mining.—The term "mining" includes not merely the extraction of the ores or minerals from the ground but also the treatment processes considered as mining described in paragraph (4) (and the treatment processes necessary or incidental thereto), and so much of the transportation of ores or minerals (whether or not by common carrier) from the point of extraction from the ground to the plants or mills in which such treatment processes are applied thereto as is not in excess of 50 miles unless the Secretary finds that the physical and other requirements are such that the ore or mineral must be transported a greater distance to such plants or mills.

(3) Extraction of the Ores or Minerals from the Ground.—The term "extraction of the ores or minerals from the ground" includes the extraction by mine owners or operators of ores or minerals from the waste or residue of prior mining. The preceding sentence shall not apply to any such extraction of the mineral

or ore by a purchaser of such waste or residue or of the rights to extract ores or minerals therefrom.

(4) Treatment Processes Considered as Mining.—The following treatment processes where applied by the mine owner or operator shall be considered as mining to the extent they are applied to the ore or mineral in respect of which he is entitled to a deduction for depletion under section 611:

(A) In the case of coal—cleaning, breaking, sizing, dust allaying, treatment to prevent freezing, and loading for shipment;

* * *

Section 614. Definition of Property.

(a) GENERAL RULE.—For the purpose of computing the depletion allowance in the case of mines, wells, and other natural deposits, the term "property" means each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land.

Section 631(c). Disposal of Coal or Domestic Iron Ore With a Retained Economic Interest.—

In the case of the disposal of coal (including lignite), or iron ore mined in the United States, held for more than 1 year[1] before such disposal, by the owner thereof under any form of contract by virtue of which such owner retains an economic interest in such coal or iron ore, the difference between the amount realized from the disposal of such coal or iron ore and the adjusted depletion basis thereof plus the deductions disallowed for the taxable

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[1] For taxable years beginning after December 31, 1977, the previous shorter holding periods were lengthened to one year. P.L. 94-455, § 1402(b)(2). Treas. Reg. § 1.631-3(a)(1) and (b)(1) does not reflect this change.

year under section 272 shall be considered as though it were a gain or loss, as the case may be, on the sale of such coal or iron ore. Such owner shall not be entitled to the allowance for percentage depletion provided in section 613 with respect to such coal or iron ore. This subsection shall not apply to income realized by any owner as a co-adventurer, partner, or principal in the mining of such coal or iron ore, and the word "owner" means any person who owns an economic interest in coal or iron ore in place, including a sublessor. The date of disposal of such coal or iron ore shall be deemed to be the date such coal or iron ore is mined. In determining the gross income, the adjusted gross income, or the taxable income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this subsection. This subsection shall have no application, for purposes of applying subchapter G, relating to corporations used to avoid income tax on shareholders (including the determinations of the amount of the deductions under section 535(b)(6) or section 545(b)(5)). This subsection shall not apply to any disposal of iron ore—

(1) to a person whose relationship to the person disposing of such iron ore would result in the disallowance of losses under section 267 or 707(b), or

(2) to a person owned or controlled directly or indirectly by the same interests which own or control the person disposing of such iron ore.

(1) Treasury Regulations on Income Tax (26 C.F.R.)

Section 1.613-1. Percentage depletion; general rule.

In the case of a taxpayer computing the deduction for depletion under section 611 with respect to minerals

on the basis of a percentage of gross income from the property, as defined in section 613(c) and §§ 1.613-3 and 1.613-4, such deduction shall be the percentage of such gross income as specified in section 613(b) and § 1.613-2. The deduction shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). Such taxable income shall be computed in accordance with § 1.613-5. In no case shall the deduction for depletion computed under this section be less than the deduction computed upon the cost or other basis of the property provided in section 612 and the regulations thereunder. The apportionment of the deduction between the several owners of economic interests in a mineral deposit will be made as provided in paragraph (c) of § 1.611-1. For rules with respect to "gross income from the property" and for defintion of the term "mining," see §§ 1.613-3 and 1.613-4. For definitions of the terms "property," "mineral deposit," and "minerals," see paragraph (d) of § 1.611-1.

Section 1.631-3. Gain or loss upon the disposal of coal or domestic iron ore with a retained economic interest.

(a) *In general.* (1) The provisions of section 631(c) apply to an owner who disposes of coal (including lignite), or iron ore mined in the United States, held for more than 6 months before such disposal under any form or type of contract whereby he retains an economic interest in such coal or iron ore. The difference between the amount realized from disposal of the coal or iron ore in any taxable year, and the adjusted depletion basis thereof plus the deductions disallowed for the taxable year under section 272, shall be gain or loss upon the sale of the coal or iron ore. See paragraph (b)(4) of this section for the definition of "owner." See paragraph (e) of this section for special rules relating to iron ore.

(2) In the case of such a disposal, the provisions of section 1231 apply, and the coal or iron ore shall be considered to be property used in the trade or business for the taxable year in which it is considered to have been sold, along with other property of the taxpayer used in the trade or business as defined in section 1231(b), regardless of whether the coal or iron ore is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Whether gain or loss resulting from the disposition of the coal or iron ore which is considered to have been sold will be deemed to be gain or loss resulting from a sale of a capital asset held for more than 6 months will depend on the application of section 1231 to the taxpayer for the taxable year; *i.e.*, if the gains do not exceed the losses, they shall not be considered as gains and losses from sales or exchanges of capital assets but shall be treated as ordinary gains and losses.

(b) *Rules for application of section.* (1) For purposes of section 631(c) and this section, the date of disposal of the coal or iron ore shall be deemed to be the date the coal or iron ore is mined. If the coal or iron ore has been held for more than 6 months on the date it is mined, it is immaterial that it had not been held for more than 6 months on the date of the contract. There shall be no allowance for percentage depletion provided in section 613 with respect to amounts which are considered to be realized from the sale of coal or iron ore under section 631(c).

Revenue Act of 1951.

Section 325. Tax Treatment of Coal Royalties.—

(a) Definition of Property Used in the Trade or Business.—Section 117(j)(1) (relating to the definition of

property used in the business) is hereby amended by adding after the word "timber" in the second sentence thereof the following: "or coal."

(b) Gain or Loss Upon Certain Disposals of Timber or Coal.—Section 117(k)(2) (relating to the disposal of timber) is hereby amended to read as follows:

"(2) In the case of the disposal of timber or coal (including lignite), held for more than 6 months prior to such disposal, by the owner thereof under any form or type of contract by virtue of which the owner retains an economic interest in such timber or coal, the difference between the amount received for such timber or coal, and the adjusted depletion basis thereof shall be considered as though it were a gain or loss, as the case may be, upon the sale of such timber or coal. Such owner shall not be entitled to the allowance for percentage depletion provided for in section 114(b)(4) with respect to such coal. This paragraph shall not apply to income realized by the owner as a co-adventurer, partner, or principal in the mining of such coal. The date of disposal of such coal shall be deemed to be the date such coal is mined. In determining the gross income, the adjusted gross income, or the net income of the lessee, the deductions allowable with respect to rents and royalties shall be determined without regard to the provisions of this paragraph. This paragraph shall have no application, in the case of coal, for the purposes of applying section 102 or subchapter A of chapter 2 (including the computation under section 117(c)(1) of a tax in lieu of the tax imposed by section 500)."

Treasury Regulations 103 (issued under Internal Revenue Code of 1939)

Section 19.23(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.—Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciaion and depletion are to be allowed.

Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because, through a contractual relation to the owner, he possesses a mere economic advantage derived from production. Thus, an agreement between the owner of an economic interest and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest.